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SUBJECT: LATVIA SET TO PASS BUDGET, CONSIDERING PAREX SPLIT AND SALE

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¶1. (SBU) Summary: The cabinet of ministers has approved a budget for 2010 that includes 500 million Lats (USD 1 billion) in fiscal consolidation demanded by international lenders. The second and final reading of the budget in the Saeima (Parliament) will take place on December 1, and the budget is expected to pass. The disposition of Parex Bank now stands as the primary economic hurdle facing the GOL, which was forced to take a majority interest in the bank in 2008 to prevent a major financial catastrophe. A break-up of the bank between performing and non-performing elements (a "good bank/bad bank" split) has been approved in principle by the cabinet, but questions remain on the best ownership structure to get Parex off the GOL books while limiting political damage to those involved in the initial takeover. It is now broadly agreed that a devaluation of the lat is highly unlikely. (Note: Finance Minister Repse will lead a team to New York on December 2 for meetings with bankers on the possible sale of Latvian Government bonds. He is not seeking meetings with USG or IMF officials, according to Ministry officials.) End Summary.

¶2. (SBU) On November 23, Deputy Assistant Secretary of Treasury for Europe and Eurasia Christopher Smart visited a number of leading figures shaping the GOL budget and banking system, including Minister of Finance Einaris Repse, IMF Chief of Mission Mark Griffiths, Bank of Latvia Governor Ilmars Rimsevics, Parex Bank CEO Nils Melngailis, Latvian Mortgage and Land Bank CEO Normans Panko, and bank regulator Irena Krumane. Interlocutors were guardedly optimistic as a government that had only months ago seemed shaky seems poised to deliver a budget that will meet international obligations. Meetings regarding the future of state-owned banks were more downbeat - although there has been progress, there are still serious disagreements on how to deal with both Parex and the Latvian Mortgage and Land Bank (LHVB).

The 2010 Budget

¶3. (SBU) The Minister of Finance and IMF representatives detailed elements of the budget agreement that is expected to be approved by Parliament on December 1. The final budget includes a rate hike from 23 to 26 percent in the personal income tax, a small, but progressive real estate tax, and increased taxes on capital gains, cars and natural gas. The budget is based on the IMF's projection of a 4 percent decline in GDP in 2010. IMF Chief of Mission Griffiths expressed reservations about the temporary nature of spending cuts, noting the GOL set many provisions to sunset in 2012, sidestepping the need for coherent structural reform.

¶4. (SBU) Minister of Finance Repse appeared confident that the budget would be approved by parliament. While he acknowledged concerns about the temporary spending cuts, he asserted that the cuts could easily be extended. Recognizing the challenge of making further adjustments in the 2011 budget given Parliamentary elections in October, Repse said taxes were high enough already, and hoped for gradual expenditure reductions including structural reform in areas

like health care. Bank of Latvia Governor Ilmars Rimsevics was vocal in expressing disappointment about the lack of structural reforms in education, health care, and public administration. He predicted a more modest decline of 1.5-2.0% of GDP in 2010.

Parex to Center Stage

15. (U) With completion of the 2010 budget, focus now turns to Parex Bank. Although some observers (including Rimsevics) think the entirety of Parex could hold positive value, the consensus is that to get it off the books, the GOL will have to recognize a loss. The Parex takeover remains poorly understood by the public and a source of a lot of public anger, with a two billion-dollar exposure to the Latvian taxpayer. As a result, some politicians are adamant that the GOL not recognize a loss at all. Furthermore, due to ongoing criminal investigations into the Parex takeover, some officials may be concerned that a significant loss could increase the risks of personal prosecution.

16. (SBU) Rather than leave the bad assets on the government books, the GOL has chosen to establish a complex structure to try to sell the assets without taking an immediate loss. The GOL has approved in principle a plan to split Parex into a good bank (or perhaps two good banks) and a bad bank, or Asset Management Company (AMC). The GOL is currently insisting that Parex find simultaneous buyers for both parts to avoid getting stuck with only the bad assets. Rimsevics is an advocate of this approach, and Repse recommended a task force on Parex disposition with Rimsevics as the chair.

17. (SBU) Parex CEO Melngailis said that some non-conventional structures were being considered in order to create a good bank and bad bank without recognizing a loss. Foremost among them would be a structure with the good bank as a subsidiary of the AMC. Melngailis recognized that this would be an unorthodox move, but said they had

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no choice but to "hide the hole" for political reasons. He sought USG assistance in convincing the GOL to recognize their losses now.

18. (SBU) Melngailis suggested a subordinated ownership structure for the AMC with private investors getting first cut at the profits, IFC and EBRD second cut, and the GOL last, essentially underwriting any losses. Krumane claimed that there are several EU buyers interested in the "good bank." She said that the IFC is doing due diligence on the AMC, but the EBRD has still not confirmed any interest.

19. (SBU) Hanging over all of this is a 300 million euro (\$447 m) syndicated loan payment due in February that Melngailis reports Parex will not be able to cover. He suggests they may need GOL assistance to provide half the payment. Krumane indicated that a portion of the IMF payments that has been earmarked for assistance to state-owned banks could be used for this purpose if necessary.

LHZB - less of an issue?

110. (SBU) The Latvian Mortgage and Land Bank (LHZB) is fully state-owned, and has a syndicated loan payment due in December. Both LHZB Chairman Panko and Krumane report that LHZB has sufficient cash to cover the loan. Enthusiasm for mixing the bad assets of LHZB and Parex in a single bad bank or AMC is waning. However, LHZB is still in a fairly tenuous situation, surviving on bilateral loans from the Nordic Investment Bank and European Investment Bank. A negative turn, such as a decline in Latvia's credit rating, could spell significant problems for LHZB -- and the GOL. Krumane claimed there is a buyer who has expressed interest in buying LHZB as is.

Devaluation Off the Table

111. (SBU) Rimsevics, who has steadfastly opposed devaluation, was happy to report that it was no longer an issue. He noted with pleasure that even Andris Skele, the head of the largest party in the governing coalition and a vocal proponent of devaluation, had

declared it too late to devalue at the People's Party congress two days earlier. Griffiths was less certain - although he seemed to be approaching it more as an intellectual exercise than a policy proposal. He noted that despite the current account surplus, many forms of analysis still showed the Lat as overvalued, which would continue act as a drag on any incipient recovery.

¶12. Comment: Completion of the 2010 budget is a positive step, but focus should remain on carrying through with serious structural reforms to prime Latvia for a steady recovery. The 2011 budget will require another 500 million lat consolidation, and will be complicated by next October's election. Before the election, nobody will want to make politically painful decisions, and after elections, the new government will be forced to work quickly to complete the budget before the end of the fiscal year. On Parex, our financially savvy interlocutors seem to recognize that losses are unavoidable, but the governing and political class has yet to come to terms with that reality. The sooner they do, the better.

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